

**REPORT OF THE AUDITOR OF PUBLIC ACCOUNTS
AGREED-UPON PROCEDURES ENGAGEMENT
OF THE
KENTUCKY CORRECTIONAL INDUSTRIES**

**For The Period January 1, 2005
Through July 31, 2005**



**CRIT LUALLEN
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CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS

October 17, 2005

John D. Rees, Commissioner
Department of Corrections
275 East Main Street, P.O. Box 2400
Frankfort, Kentucky 40602-2400

Independent Accountant's Report

Dear Commissioner Rees:

We have performed the procedures enumerated below, which were agreed to by the Kentucky Department of Corrections (DOC), solely to assist you with evaluating specified Kentucky Correctional Industries (KCI) processes. KCI management is responsible for the internal controls regarding the specified financial processes from January 1, 2005 through July 31, 2005. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of DOC and consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

Our procedures, conclusions, and findings follow this letter.

We were not engaged to, and did not conduct an audit, the objective of which would be the expression of an opinion, on the specified financial processes. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the DOC and KCI, and is not intended to be and should not be used by anyone other than these specified parties.

Respectfully submitted,

A handwritten signature in cursive script, appearing to read "Crit Luallen".

Crit Luallen
Auditor of Public Accounts

Engagement fieldwork completed -
September 23, 2005



KENTUCKY CORRECTIONAL INDUSTRIES

EXECUTIVE SUMMARY

Kentucky Correctional Industries (KCI), as with several other government agencies, has a special mission to operate with the accountability and oversight of a government agency, provide training opportunities to facilitate inmates to transition to jobs after incarceration and operate in a business manner comparable to the private sector.

During the course of this review, we have identified problems encountered by KCI that restrict it from performing at its maximum potential due to its operating environment imposed by other state agencies.

We recommend that the Department of Corrections, the Finance and Administration Cabinet, the Governor's Office for Policy and Management, the Legislative Research Commission and the Commerce Cabinet review business practices which are essential to fulfill KCI's mission and submit a plan to the General Assembly for any necessary statutory revisions. A business plan with appropriate checks and balances to promote sales and provide accountability and oversight can be achieved. The APA does not provide audit services for these specific business activities; however, we are confident that a workable business plan can be implemented, and we stand ready to assist KCI.

In the eleven months since the APA performed the prior review, KCI has made improvements in its operations. There is still more work to do, but the Department of Corrections appears to be committed to making the necessary changes. With a limited number of staff, segregation of duties will always be an issue; however, KCI is working to overcome these limitations.

During the course of our engagement, KCI management expressed the following management perspectives and programmatic justification for this program. The purpose of including this statement is to reflect KCI's overall mission.

KCI personnel stated:

"The wardens like the KCI program and say that a tired prisoner is a good prisoner. The KCI program is often credited with reducing the overall tension levels in the prisons. One key KCI goal is to keep inmates busy with productive work. The KCI inmates are trained for the work and they might be able to do this type work after their release."

A 2001 study by Eastern Kentucky University found the following:

"39% of all inmates return to prison within a year of release. Only 13.5% of KCI inmates return to prison within a year of release."

Based on this study, KCI personnel contend the KCI program causes a drastic reduction in inmates returning to prison.

KENTUCKY CORRECTIONAL INDUSTRIES
AGREED UPON PROCEDURES

1. Review internal controls over receipts and review relevant compliance. Test 25 receipts transactions. The receipts transaction testing will include testing the timeliness of receipts deposited.

Internal controls over receipts are inadequate due to matters addressed in report comment #1 about administrator rights and report comment #5 regarding financial monitoring activities. We cannot determine whether all checks received were logged into the check log and deposited into Treasury. Some checks are not deposited timely due to sales orders not being promptly prepared and entered. See report comment #8 "Sales Orders Should Be Entered Promptly."

2. Review internal controls over accounts receivable and review relevant compliance. Test 50 accounts receivable transactions. The accounts receivable transaction testing will include testing reductions in accounts receivable balances for appropriate receipt documentation related to payments received.

Internal controls over accounts receivable are inadequate due to matters addressed in report comment #1 about administrator rights and report comment #5 regarding financial monitoring activities. We found two minor errors that would have been corrected if KCI had been conducting monthly reconciliations. See part 6 of report comment #7 regarding the prior audit report.

3. Review internal controls over billing. Test 25 billing transactions. The billing transaction testing will include remittance advices, sales invoices, entries recorded in ACCPAC and MARS, and inter-account transaction handling.

Internal controls over billing are inadequate due to matters addressed in report comment #1 about administrator rights, report comment #5 regarding financial monitoring activities, and report comment #8 concerning sales orders.

4. Review a copy of the policies and procedures manual to see if updated.

KCI's policies and procedures have been updated, but not approved by the Department of Corrections. The policies and procedures for the Fiscal Affairs Branch have not been written. Without a complete policies and procedures manual in place, the Fiscal Affairs Branch employees do not have a full description of their duties. See comment #6 related to policies and procedures.

**KENTUCKY CORRECTIONAL INDUSTRIES
AGREED UPON PROCEDURES
(CONTINUED)**

5. Conduct follow-up on the recommendations noted in the November 2004 APA special examination report on KCI.

KCI has resolved 4 of the 9 recommendations. KCI should continue to address each unresolved issue. A spreadsheet, or similar approach, should be used to track progress on a quarterly basis. These quarterly progress reports should be provided to the KCI Director and the Department of Corrections central office.

See report comment #7 related to the prior audit report.

6. Reconcile ACCPAC to MARS at July 1, 2005.

When reconciling ACCPAC to MARS, we found 59 errors. The errors were due to KCI failing to conduct a monthly reconciliation between ACCPAC and MARS. The annual FY closeout should provide a clean cut-off between the fiscal years to correctly adhere to accounting principles involving consistency. A computerized reconciliation process should be created and conducted as noted in the prior audit report. See part 6 of report comment #7 addressing the prior audit report.

7. Review policies and procedures used in inventory record keeping. Review internal controls and segregation of duties over inventory.

There are unwritten policies and procedures used for inventory record keeping. Internal controls and segregation of duties over inventory are adequate. See comment #9 about KCI budget and operating capital.

KENTUCKY CORRECTIONAL INDUSTRIES
COMMENTS AND RECOMMENDATIONS

Comment #1: Administrator Rights For The Internal Accounting System (ACCPAC) Should Be Restricted

Four employees have administrator rights related to the internal accounting system known as ACCPAC. A person who has administrator rights for an accounting software package can perform the following functions:

- grant and take away access to perform all transactions,
- create new user security profiles,
- modify existing user security profiles,
- reset passwords, and
- add, delete, or modify any transaction data.

Special privileges or authorizations, such as accounting software administrator rights, are normally assigned to a limited number of individuals. These individuals are the primary and backup personnel who require those rights to perform their jobs. Accounting software administrator duties are incompatible with accounting duties.

Two of the four people who have administrator rights are network analysts and this is acceptable due to their other duties. However, the third person who has administrator rights is the fiscal manager, who also has accounting duties. The fourth person who has administrator rights is the chief financial officer, who also has accounting duties.

The fiscal manager creates or modifies the ACCPAC user security profiles, and resets passwords. The chief financial officer resets passwords as well. The ACCPAC security access profiles are created and modified without a written request or written approval. ACCPAC does not keep a log of the changes made by any of the administrators.

This is a clear segregation of duties problem. A person with administrator rights can bypass computer controls. When a person has both administrator rights and accounting duties, they could perpetrate and conceal fraudulent activity. There is an especially high risk when an accounting software administrator has physical control over receipts. Both the chief financial officer and the fiscal manager are accounting software administrators with access to receipts.

Recommendation:

We recommend that personnel with accounting duties do not have administrator rights to the accounting software. In the event KCI management concludes it cannot separate the administrator rights from the accounting duties, we believe it is critical to prohibit accounting software administrators from having physical control over receipts.

The Chief Financial Officer should approve user profiles for ACCPAC security access in writing. Also, ACCPAC security access changes should be approved in writing by the Chief Financial Officer and be based on need.

**KENTUCKY CORRECTIONAL INDUSTRIES
COMMENTS AND RECOMMENDATIONS
(CONTINUED)**

Comment #2: KCI Should Evaluate Its Internal Accounting Software Package

Kentucky Correctional Industries uses an internal accounting software package called ACCPAC. Based on inquiries and observations, we found no evidence that ACCPAC has the necessary features or that the features have been selected and implemented. These deficiencies indicate the following may be occurring:

- Inappropriate authority levels;
- Reconciliation of financial information not being performed;
- Independent supervisory review of the reconciliation process not being performed;
- Inadequate monitoring of operations and financial performance; and
- Follow-up corrective action not taken as necessary.

Accounting software usually:

- Keeps a record related to all transactions:
 - showing who entered the transaction,
 - showing who approved the transaction, and
 - showing any modifications to each transaction.
- Has Level 1 security for original entry of transactions and level 2 security for approval of the transactions. Level 1 users cannot make level 2 entries and level 2 users cannot make level 1 entries.
- Tracks and reports adjustments related to each transaction.
- Monitors and reports on activities such as:
 - security violation reports, and
 - reconciliation reports

Recommendation

We recommend that KCI determine:

- Whether each of the software features noted above is already available for the ACCPAC software version installed,
- Whether any of these features can be cost effectively implemented,
- Whether any of these features are available from the software vendor for a reasonable cost, and
- Whether any of these features not in the currently installed software could be added to the ACCPAC version and implemented for a reasonable cost.

**KENTUCKY CORRECTIONAL INDUSTRIES
COMMENTS AND RECOMMENDATIONS
(CONTINUED)**

Comment #3: KCI Should Improve Controls Over Receipts

When mail is received within the KCI Frankfort office, an employee opens the mail and restrictively endorses each check. The checks and other related mail are passed along to the Chief Financial Officer. When the Chief Financial Officer is not available, the Fiscal Manager handles the receipts before they are passed along to the accountant who creates the CR document.

KCI receives funds from customers:

- Paying for goods purchased on the showroom floor.
- Purchasing goods direct at a plant site.
- Telephoning in a purchase and using a credit card for payment.
- Mailing in a payment for goods.
- Paying by an inter-account with state agencies.

The first three receipts arrival routes noted above are not under the direct control of KCI accounting. Control over receipts needs to be established at the entry point. These first three receipts routes do not use a separate receipts log.

The fourth receipts arrival route noted above involves mail receipts. Cash receipts listings are frequently used to document cash received through the mail. KCI is using such a cash receipts listing.

Receipts logs can be used later to make independent comparisons of the cash collections recorded and deposited in the agency's account. The duties of receiving cash and preparing the initial documentation should be segregated from the duties of making entries in the accounting system, posting the cash collections, and depositing them.

Recommendation:

We recommend the following procedures be considered:

- KCI should designate a few individuals within the KCI Frankfort location to accept receipts from walk in customers. Appropriate segregation of duties should be in place.
- KCI should complete a mail log and receipts listing promptly. Personnel not involved with accounting duties for receipts, accounts receivable, or billings should handle the mail and receipts listing. Someone who does not handle cash receipts should subsequently trace the complete receipts listing to the deposit.

**KENTUCKY CORRECTIONAL INDUSTRIES
COMMENTS AND RECOMMENDATIONS
(CONTINUED)**

Comment #4: KCI Should Consider Using More Financial Reporting Techniques Using The Internal Accounting Software

KCI should determine if ACCPAC, the internal accounting system, is capable of providing more useful management reports.

The Division could create monthly receipts reports by type of receipt (checks, money orders, credit card receipts, currency and coins). The reports could compare receipts data: month to month, quarter to quarter, July current year to July prior year, averages for each of the past two years to the most recent month, and percentage of each type receipt.

There are no periodic reports showing adjustments or transactions that have been reversed or backed-out. The data may be available but it is not being reported or monitored. These would include changes or deletions related to receipts, accounts receivable, and billings records. Adjustments are often used to perpetrate or hide frauds. When adjustments are reported and reviewed, the fraud risk is reduced to an acceptable level. These adjustment transactions should be viewed as sensitive transactions and reports should be created to review and monitor these type transactions.

Recommendation:

We recommend that the Division try to improve its financial reporting techniques.

We recommend that the Division identify and report on all adjustments. These reports should be produced at least monthly. The data tracked by such reports might include but not be limited to: date of the transaction, user ID making the adjustment, amount of the adjustment, the nature of the adjustment, and the reason for the adjustment.

Comment #5: KCI Should Develop and Implement Financial Monitoring Procedures

We found no evidence of independent reconciliations of financial information or sufficient supervisory review of financial activities. Performing reconciliations and independent supervisory reviews are key components of proper internal controls. These matters are addressed below.

1. ACCPAC assigns a sales order number to each sales order entered into ACCPAC. A separate sales order is prepared related to each plant site even though the original hand-written purchase order might have been for goods produced at three different plant sites. There is no evidence that the sales orders are all accounted for by KCI. There is no evidence that the sales orders are reconciled to the related invoice amounts and adjustments.

**KENTUCKY CORRECTIONAL INDUSTRIES
COMMENTS AND RECOMMENDATIONS
(CONTINUED)**

Comment #5: KCI Should Develop And Implement Financial Monitoring Procedures (Continued)

2. The purchase orders, sales orders, shop orders, packing slips, invoices, and receipts related information, accounts receivable, and adjustments are not reconciled within each group, to ACCPAC, or to MARS.

There are no reports reconciling receipts to deposits in ACCPAC and/or MARS. There is no monthly report summarizing and reconciling all receipts recorded by the fiscal management branch to the monies actually deposited into Treasury. Due to some timing differences, the receipts may not exactly match the deposits; however, the amounts should be close over several months. There are currently no reports or reconciliations related to credit card receipts.

Recommendation:

We recommend KCI create and use receipts reports to monitor activities and perform reconciliations. The agency should conduct the following periodic reconciliations:

1. Someone independent of the cash receipts function should summarize cash receipts. This cash summary should be compared to the Treasury deposits to ensure that all collections are deposited intact. Another approach would be to compare deposits of receipts into MARS to ACCPAC.
2. Someone independent of the cash receipts function should reconcile the mail log to the daily cash and receipts activity.
3. Someone should subsequently compare the actual currency and coins deposited with the actual currency and coins received.
4. The total credit card payments recorded in the internal accounting system should be reconciled with the total credit card payments shown in MARS.
5. Appropriate management should follow up all differences found in the reconciliations. KCI should document these reconciliations as well.

**KENTUCKY CORRECTIONAL INDUSTRIES
COMMENTS AND RECOMMENDATIONS
(CONTINUED)**

Comment #6: KCI Accounting Policies And Procedures Should Be Updated, Communicated, And Monitored

KCI's policies and procedures have been updated since our 2004 report, but not approved. Written policies and procedures provide for consistent preparation of work product, ensure that staff is aware of management's expectations, provides staff with guidance when questions arise, assists in training new employees, and reduces the risk of misunderstanding in oral explanations.

The policies and procedures for the Fiscal Affairs Branch have not been written. Without a complete policies and procedures manual in place, the Fiscal Affairs Branch employees do not have a full description of their duties. This creates potential control weaknesses.

Recommendation:

We recommend that KCI finish updating the policies and procedures to cover the weaknesses found while conducting this review. The policies and procedures manual should be given to all employees. Periodically, management should conduct reviews to ensure personnel are adhering to written policies and procedures.

Comment #7: KCI Should Adhere To Its Corrective Action Plan Stated In The 2004 APA Special Examination Report

On November 15, 2004 the Kentucky Auditor of Public Accounts issued an audit report titled "Special Examination of Kentucky Correctional Industries." As part of the 2005 KCI agreed-upon procedures engagement, we followed up on each report recommendation.

1. Prior Comment: Inadequate segregation of duties had significant impact on KCI financial processes. We recommend that KCI continue to provide transaction documentation to Corrections' management for independent review. Further, we recommend that KCI's Chief Financial Officer (CFO) be responsible for the reconciliation duties and perform an additional independent review of financial activity reports.

Agency Response: To alleviate concerns of management review and reconciliation, the CFO will compare his check log to the cash transmittal form to ensure accuracy. The above documentation will be forwarded to an Internal Policy Analyst at the Department of Corrections Central Office.

Current Action: The CFO is adhering to this. The information has been provided on a periodic basis to two people in the Central Office. The information provided to the Central Office included "checks received" by KCI and a monthly "comparison of revenue and expenditures (cash basis)."

**KENTUCKY CORRECTIONAL INDUSTRIES
COMMENTS AND RECOMMENDATIONS
(CONTINUED)**

**Comment #7: KCI Should Adhere To Its Corrective Action Plan Stated In The 2004
APA Special Examination Report (Continued)**

2. Prior Comment: We recommend that KCI restrictively endorse checks immediately upon receipt. The individual assigned to open incoming mail should make the endorsement.

Agency Response: The Director's Administrative Specialist retrieves checks from the daily mail and restrictively endorses the checks (For Deposit Only/KCI). The checks are given to the CFO who adds them to a check log and then forwards them to the Fiscal Manager for review.

Current Action: The Director's Administrative Specialist is performing this activity, so KCI is adhering to what they said. The checks are being given to the CFO to log the checks. When the CFO is not on site, the checks are often given directly to the Fiscal Manager to record in the check log. In some instances, the checks are taken directly from the mail opener to the person who prepares the deposit for Treasury.

Recommendation: The check log should be prepared by the mail opener (Administrative Specialist), who restrictively endorses the checks. Also, the CFO and Fiscal Manager should not be handling receipts due to their other accesses and duties. **See report comments #1 and #3.**

Agency Response: "The checks being processed are stored in a secured safe located in the AR Specialist's office."

Current Action: This was true on November 15, 2004. The AR Specialist was reassigned to handle accounts payable and the safe remained in her office. The Fiscal Manager and Accounts Payable Specialist (AP) are the only ones with the combination to the safe.

The mail opener receives checks and other receipts. The AR Specialist who prepares the deposits is responsible for the checks. No one else in the accounting area should be responsible for checks.

**KENTUCKY CORRECTIONAL INDUSTRIES
COMMENTS AND RECOMMENDATIONS
(CONTINUED)**

**Comment #7: KCI Should Adhere To Its Corrective Action Plan Stated In The 2004
APA Special Examination Report (Continued)**

3. Prior Comment: We recommend that KCI continue to forward cash receipts to Treasury on a daily basis for deposit. We recommend that KCI continue its efforts to ensure all amounts posted as paid in ACCPAC are deposited in the most expeditious manner possible.

Agency Response: The Accounts Receivable (AR) Specialist next receives these items to process and forwards to the Kentucky State Treasurer with a cash receipts transmittal form. This process will be performed on a daily basis.

He (the CFO) will also confirm that the deposit reached the Kentucky State Treasurer.

Current Action: This is occurring; however, KCI is not forwarding cash receipts to Treasury as soon as feasible because checks are held until a sales order is entered into ACCPAC. **See comment #8 “Sales Orders Should Be Entered Promptly.”**

The confirmation that the deposit reached the Kentucky State Treasurer appears to be happening but is not separately documented. The CFO should document the confirmation.

4. Prior Comment: We recommend that KCI instruct and require its sales staff to complete sales orders using the master listing of existing customers and customer numbers to eliminate assigning new customer numbers to already existing customers.

Agency Response: The prior report response did not address this.

Current Action: KCI has improved this process and continues to work on this.

5. Prior Comment: We recommend that KCI send remittance advices along with sales invoices mailed to its customers.

Agency Response: To assist our Accounts Receivable Specialist in determining where to credit payments, we will begin to send remittance advices along with the sales invoices mailed to our customers.

Current Action: This is being done. However, not all customers return the remittance advices and this is typical of all retail operations.

**KENTUCKY CORRECTIONAL INDUSTRIES
COMMENTS AND RECOMMENDATIONS
(CONTINUED)**

**Comment #7: KCI Should Adhere To Its Corrective Action Plan Stated In The 2004
APA Special Examination Report (Continued)**

6. Prior Comment: We recommend that KCI continue to produce accounts receivable aging reports for management. KCI should investigate items outstanding longer than 30 days. Ideally, the report should be distributed to an individual not involved in the cash receipts transaction process, such as the CFO, and others for review.

Agency Response: The CFO will also review on a daily basis a centralized accounts receivable aging report of all the different plants in KCI. This report is presently being constructed by our software vendor and is to be implemented within two weeks.

Current Action: This is being done informally. It is not being documented. The CFO and fiscal manager discuss the accounts receivable aging report on a monthly basis. The accounts receivable aging report is being produced. The CFO and fiscal manager are both involved in the cash receipts transaction process, so this part has not been adhered to by KCI.

7. Prior Comment: We recommend KCI continue to attempt to reconcile the discrepancy between ACCPAC and MARS. To facilitate the reconciliation process in the future, we further recommend that KCI require the transaction reference number be entered in ACCPAC. Transaction data from ACCPAC and MARS should be reconciled monthly. The reconciliation should be performed, or at least reviewed, by someone not involved in routine daily operations. Monthly, the CFO should review amounts entered in ACCPAC and reconcile the amounts to data entered in MARS.

Agency Response: We understand the weakness cited concerning inconsistent data entry. In response, we are now using a common data field in MARS (State accounting system) and in ACCPAC (KCI accounting system) that includes the same information for a specific cash receipts transaction. This will allow these transactions to be reconciled with each other. The prior report response did not address this.

Current Action: MARS document numbers are being entered into ACCPAC. KCI is not reconciling MARS and ACCPAC. Any discrepancies between ACCPAC and MARS should be resolved during the reconciliation process. **See report comment #5 on financial monitoring activities.**

**KENTUCKY CORRECTIONAL INDUSTRIES
COMMENTS AND RECOMMENDATIONS
(CONTINUED)**

**Comment #7: KCI Should Adhere To Its Corrective Action Plan Stated In The 2004
APA Special Examination Report (Continued)**

8. Prior Comment: We recommend that KCI add an additional field or sub-field in ACCPAC that allows the same unique data for a specific transaction to be entered into MARS.

Agency Response: We understand the weakness cited concerning inconsistent data entry. In response, we are now using a common data field in MARS (State accounting system) and in ACCPAC (KCI accounting system) that includes the same information for a specific cash receipt transaction. This will allow these transactions to be reconciled with each other.

Current Action: MARS document numbers are being entered into ACCPAC; however, they are using a shorter version such as leaving out the 527 on inter-account documents and leaving out zeros on CR documents. Thus, the document number is meaningful but a computer match to MARS might not work well due to these minor omissions. KCI is not conducting a reconciliation between MARS and ACCPAC. **See report comment #5 on financial monitoring activities.**

9. Prior Comment: We recommend that KCI update its policies and procedures manual for all its internal operations.

Agency Response: Along with the above procedures, modification and development of all written accounting policies at KCI is now underway. We note these have not been modified since the 1980s and do not reflect our current operations. However, it is our belief that with the current staffing levels, we have the necessary personnel to ensure proper segregation of duties.

Current Action: They have now drafted modified policies and procedures, which have not yet been approved. The new draft does not provide sufficient policies and procedures related to the accounting function. **See report comment # 6 on policies and procedures.**

**KENTUCKY CORRECTIONAL INDUSTRIES
COMMENTS AND RECOMMENDATIONS
(CONTINUED)**

**Comment #7: KCI Should Adhere To Its Corrective Action Plan Stated In The 2004
APA Special Examination Report (Continued)**

10. Prior Comment: We recommend that KCI continue to pursue payment from customers whose original checks cannot be processed by banks due to the time period elapsed since the original date of payment.

Agency Response: The prior report response did not address this.

Current Action: KCI personnel informed us that they have collected 170 (\$306,969.21) of the 250 checks (\$346,348.12) noted in the 2004 special examination report. Of the remaining, 26 checks have not been collected and 54 were cancelled as not being owed to KCI.

Recommendation: The Chief Financial Officer should ensure that the status of the remaining 26 checks is resolved.

Recommendation

KCI should continue to address each unresolved issue noted above. A spreadsheet, or similar approach, should be used to track progress on a quarterly basis. These quarterly progress reports should be provided to the KCI Director and the Department of Corrections central office.

Comment #8: Sales Orders Should Be Entered Promptly

Before the Sales Branch creates the sales order, the sales person creates a hand written customer order. The customer order form is used to create a sales order related to each plant needed to produce the goods being ordered. For example, one customer order might cause three different sales orders to be generated. The sales orders are sometimes not entered into ACCPAC for two weeks, which is a frequent occurrence. The sales branch manager confirmed this time lag on entering some sales orders. The time delay is due to the person assigned to enter sales orders being assigned other higher priority tasks.

When sales orders are not entered timely, fiscal affairs has difficulty processing a payment correctly. They need the sales order to know which plant and customer number to post the payment. Checks cannot be correctly posted to ACCPAC until the sales order is entered. Therefore, the person preparing the deposit holds the checks until a sales order is entered.

**KENTUCKY CORRECTIONAL INDUSTRIES
COMMENTS AND RECOMMENDATIONS
(CONTINUED)**

Comment #8: Sales Orders Should Be Entered Promptly (Continued)

The plants usually do not get a shop order or other authorization to order materials and start production until a sales order is received. The plants cannot order the raw materials to produce the goods until they have a sales order.

The central warehouse cannot ship goods out of the warehouse until the supporting paperwork, which begins with a sales order, is in place. When the goods sold are stocked for the central KCI warehouse and the sales order is not promptly entered, a same day sale or next day sale could create problems.

The sales orders being entered into ACCPAC drive many other activities. The failure to enter sales orders on a daily basis disrupts other KCI activities noted above.

Recommendation

We recommend that KCI ensure sales orders are entered by the end of the following workday. One approach is to have each plant enter its sales orders. A second approach, which should provide more accuracy and consistency, is to have a person at KCI headquarters handle all of the sales order data entry. However, a centralized approach demands that sufficient staff resources be committed to assure timely processing.

Comment #9: KCI Budget And Operating Capital

Before the Sales Branch creates the sales order, the sales person creates a hand written customer order. KCI has to have a sales order entered before they can proceed to produce goods. The budget and operating capital constraints imposed on KCI were difficult during the last 15 months due to sales increasing by over 28%. During the same period, a few plants have been closed and a few new plants have been opened (the Finance printing plant is proving to be especially expensive to get ready and KCI personnel stated over \$400,000 in up-front cost could not be reasonably anticipated). KCI personnel stated that new equipment purchases have been made for the plants.

The Division is not able to purchase raw materials in economical order sizes due to limited operating capital and having to have an order in hand before ordering raw materials. This causes KCI to submit raw material orders for less than the optimum size.

**KENTUCKY CORRECTIONAL INDUSTRIES
COMMENTS AND RECOMMENDATIONS
(CONTINUED)**

Comment #9: KCI Budget And Operating Capital (Continued)

The constraints prevent KCI from being able to take a sales order and promptly deliver goods to a customer. Since KCI cannot order raw materials until they have an order in hand, KCI is handicapped on lead times. They cannot start the job until they get the sales order and the raw materials. Next, they have to produce the goods before the goods can be shipped. The entire KCI process takes longer from sales order to delivery than its competitors.

KCI is also not in a strong financial position to keep a large finished goods inventory on hand so it can maximize sales. This is especially true for the May and June time period when sales are often the highest since many state agencies defer purchasing until the 4th quarter.

The KCI budget and shortage of operating capital also makes it difficult to make timely payments to vendors. This also causes KCI to miss prompt payment discounts. The tight KCI budget and operating capital shortage creates operational challenges.

Recommendation:

We recommend that KCI work with the Finance and Administration Cabinet, the Governor's Office for Policy and Management, the Legislative Research Commission and the Commerce Cabinet to increase KCI's operating capital. The KCI growth and expansion needs to be properly addressed for the next biennial budget. In addition, the budget appropriation and allotment needs to be properly monitored.

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AGENCY RESPONSE



JUSTICE AND PUBLIC SAFETY CABINET

Ernie Fletcher
Governor

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John D. Rees
Commissioner

MEMORANDUM

TO: Crit Luallen, State Auditor
Auditor of Public Accounts

FROM: John D. Rees, Commissioner
Department of Corrections
John D. Rees
Michael O'Laughlin, Director
KY Correctional Industries

DATE: November 14, 2005

RE: Kentucky Correctional Industries

The following is Kentucky Correctional Industries' response to the Independent Accountant's Report dated October 17, 2005.

Comment #1: Administrator Rights for the Internal Accounting System (ACCPAC) Should be Restricted

Kentucky Correctional Industries' (KCI) has reviewed this recommendation and concluded that it is not practical to separate administrator right to the accounting software. The accounting software administrators do not have any physical control over receipts.

Current procedures have the Administrative Assistant receiving payments and maintaining the checks received log. The Accountant processes receipt transactions and forwards all checks to the State Treasury. The Chief Financial Officer and the Fiscal Manager do not handle the receipts.

All ACCPAC security access changes will be approved in writing by the Chief Financial Officer.

Comment #2: KCI Should Evaluate Their Internal Accounting Software Package

KCI has held one initial meeting with a consultant to discuss accounting software requirements. Additional discussions will be held with other state prison industries to review the systems they currently are using and the cost of such software. A committee representing the various functions within industries will be established to further outline the needs and requirements of accounting system and to determine if ACCPAC is an option. If ACCPAC is not an option, a new system will have to be found.

Comment #3: KCI Should Improve Controls Over Receipts

KCI has controls in place to monitor receipts. The salesman in charge of the Frankfort location will receive receipts from walk in customers. They will immediately forward those receipts to the Administrative Assistant. The Administrative Assistant will log the receipts in the checks received register.

The Administrative Assistant will maintain the checks received register. This register is maintained on a daily basis and the receipts are forwarded to the Accountant for depositing in the State Treasury. The Chief Financial Officer and Fiscal Manager do not handle any receipts. The Accountant provides a copy of the deposit information that is used by the Fiscal Manager to verify all checks are deposited and entered in MARS and ACCPAC.

Comment #4: KCI Should Consider Using More Financial Reporting Techniques Using the Internal Accounting Software

KCI is working on developing formalized financial reporting. To the extent possible reports from ACCPAC are being used to review sales and account receivable balances. A meeting with all field Operation Managers was held and direction given to improve the information that they are forwarding on a monthly basis. This information will be used to provide other financial reports. Until a complete accounting software package is in place, KCI will have to merge data from several areas, i.e. MARS, ACCPAC and the field sites, to develop financial reports.

All adjustment will be reviewed by the Fiscal Manager and forwarded to the Chief Financial Officer for final review and approval.

Comment #5: KCI Should Develop and Implement Financial Monitoring Procedures

KCI currently has an informal review proceed in place that compares the checks received register, credit card payments, currency and coins and inter account payments. The

reconciliation process insures that the information entered in MARS and ACCPAC are in agreement and that they agree with the source information, i.e. the check received register.

The Fiscal Manager will formalize this review process, document the review and forward to the Chief Financial Officer for final review and approval.

Comment #6: KCI Accounting Policies and Procedures Should be Updated, Communicated and Monitored

KCI has completed the Policies and Procedures Manual, with the exception of the fiscal areas, and has forwarded it to LRC for review and approval. Copies of the manual have been distributed to all field locations.

The fiscal section of the manual is being developed and will be forwarded for review and approval after completion.

Comment #7: KCI Should Adhere to its Corrective Action Plan Stated in the 2004 APA Special Examination Report

KCI continues to review and address the recommendations from the 2004 report. Issues that have not been completely resolved are being investigated and corrective action taken. KCI is developing, documenting and implementing changes necessary to address any open item from the 2004 report as well as the current review.

Comment #8: Sales Orders Should be Entered Promptly

KCI is currently loading the majority of the sales orders in the Central Office. As positions are realigned in the sales department, some orders are being loaded by salesmen in the field. KCI is working towards having all orders loaded in the field. KCI will monitor the timeliness of all orders entered with a goal of a twenty four hour turnaround.

Comment #9: KCI Budget and Operating Capital

KCI is working with the various agencies to increase its operating budget. The budget appropriation and allotment report is being monitor on a weekly basis.

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AUDITOR RESPONSE

Auditor Response:

We have carefully reviewed the Department of Corrections response to our report of Kentucky Correctional Industries (KCI).

The Department of Corrections is making significant efforts to improve the financial management of KCI. We understand the limitations regarding segregation of duties; however, KCI should take necessary action to implement compensating controls. We have discussed this matter with KCI for their further action.